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STATE OF MONTANA

TEACHERS' RETIREMENT SYSTEM

REPORT ON AUDIT

Conducted Under Contract By
Holmes and Turner, CPA's

Two Fiscal Years Ended June 30, 1976

PLACEMENT

JOHN C. EUBAR
Montana State Auditor
Montana State Capitol
Helena, Montana 59610



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OVERVIEW

AUDIT OF

THE TEACHERS RETIREMENT SYSTEM

January 1977

INTRODUCTION

The audit of the Teachers Retirement System was a financial-compliance audit. The purposes of the audit were to determine whether the financial operations of the agency fund of the system was properly conducted, whether the financial statements for the two fiscal years ending June 30, 1976 were presented fairly and whether the system complied with the applicable laws and regulations. Our examination was limited to the system's trust funds and did not include an examination of any investments other than land and buildings.

The audit resulted in a qualified opinion on the system's financial statements relating to the agency fund in total, and a disclaimer of opinion on the Annuity Savings Fund, Pension Accumulation Fund and Annuity Reserve Fund. A qualified opinion means that the financial statements present fairly the financial position, operations and changes in fund balances in conformity with generally accepted accounting principles, except as specifically noted. A disclaimer of opinion means that the condition of the accounting records was such that we could not perform all audit tests which we considered necessary to form an opinion as to the fairness of the financial statements.

There are 18 recommendations in the audit report. The system's officials concurred with 14 of the recommendations. They did not concur with 4 of the recommendations. The full texts of the system's written responses to the audit report are included in the report beginning on page 27.

SYNOPSIS OF MAJOR FINDINGS

There are several areas of major finds presented in the audit report.

General Ledger

A major inadequacy exists in the accounting procedures employed by the retirement system in that the general ledger which is provided by the Statewide Budgeting and Accounting System (SBAS), has not been adapted to provide the information which is required to prepare meaningful financial statements. Additionally, the various funds which combine to form the agency fund are not being maintained individually as required by State law. In order to prepare financial statements we had to analyze each account within the general ledger and segregate each transaction by the various funds which were affected.

In order to alleviate this problem we recommend in our audit report that the retirement system perform the necessary procedures to adapt the general ledger provided by SBAS to their specific requirements. This includes the establishment of subsidiary ledgers which will provide the necessary information to segregate each transaction by the various fund which is affected so that individual fund balances can be established and maintained.

Membership Savings Accounts

The retirement system is required to maintain individual savings accounts for each active member of the system. Due to the incomplete conversion from a manual to a computerized system for these accounts we were unable to obtain a balanced listing of the membership savings accounts for the period ending June 30, 1976. The lack of these balances prevented us from confirming them with a random sample of the individual members and has caused us to disclaim an opinion in regard to this area.

The conversion process which began over two years ago appears to be in its final stages. We recommend in our audit report that every effort should be taken to complete the conversion process as soon as possible.

Internal and Accounting Controls

We have made other recommendations in the audit report designed to improve the internal and accounting controls of the system. These recommendations deal with several aspects of the retirement system's operations including accounts receivable, delinquent contribution reports, journal entries, cash receipts, benefit payments, budgets, retirement board minutes, depreciation expense and the verification of reported wages. These recommendations are designed to improve the quality of the retirement system's control over assets and transactions and improve the quality of its financial reporting and accountability.

STATE OF MONTANA

Office of the Legislative Auditor



STATE CAPITOL
HELENA, MONTANA 59601
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MORRIS L. BRUSETT
LEGISLATIVE AUDITOR

February 7, 1977

DEPUTY LEGISLATIVE AUDITORS:

JOSEPH J. CALNAN
ADMINISTRATION AND
PROGRAM AUDITS

ELLEN FEAVER
FINANCIAL-COMPLIANCE AND
CONTRACTED AUDITS

STAFF LEGAL COUNSEL
JOHN W. NORTHEY

The Legislative Audit Committee
of the Montana State Legislature:

Transmitted herewith is the report on the audit of the Teachers'
Retirement System for the two fiscal years ended June 30, 1976.

The audit was conducted by Holmes and Turner, CPA's, under a
contract between the firm and our office. The comments and recommen-
dations contained in this report represent the views of the firm and not
necessarily the Legislative Auditor.

The agency's written response to the report recommendations is
included in the back of the audit report.

Respectfully submitted,

Morris L. Brusett

Morris L. Brusett, C.P.A.
Legislative Auditor

STATE OF MONTANA
TEACHERS' RETIREMENT SYSTEM
AUDIT REPORT
TWO FISCAL YEARS ENDED JUNE 30, 1976

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TEACHERS' RETIREMENT SYSTEM

ELECTIVE, APPOINTIVE, AND ADMINISTRATIVE OFFICIALS

<u>BOARD OF DIRECTORS</u>	-	June 30, 1976	<u>Term</u>	<u>Expires</u>
James E. Burke, Chairman			Livingston	July 1, 1976
J. William Kearns Jr., Vice Chairman			Townsend	July 1, 1977
James N. Dennely			Butte	July 1, 1978
Lorence B. Simonsen			Shelby	July 1, 1979
Dolores Colburg, State Superintendent of Public Instruction				Ex Officio

ADMINISTRATIVE OFFICIALS

Owen L. Morris, Jr., Executive Secretary

F. Robert Johnson, Assistant Executive Secretary

SUMMARY OF RECOMMENDATIONS

As a separate section in the front of each audit report we include a listing of all recommendations together with a notation as to whether the agency concurs or does not concur with each recommendation. This listing serves as a means of summarizing the recommendations contained in the report and the audited agency's reply thereto and also as a ready reference to the supporting comments. The full reply of the Teachers' Retirement System is included in the back of this report.

	<u>Page</u>
Substantial receivables should be accrued at the end of each fiscal year.	7
<u>Agency Reply:</u> Concur. See page 27.	
Consider proposed legislation which would allow for penalties to reporting agencies for failure to file timely contribution reports.	7
<u>Agency Reply:</u> Do not concur. See page 27.	
Include on all journal entries a precise explanation of the nature of the entry and refer to the source where detailed information is available.	8
<u>Agency Reply:</u> Concur. See page 28.	
Segregate the functions of accounting from the receipt and deposit of funds relating to investments in real estate mortgages.	9
<u>Agency Reply:</u> Do not concur. The agency maintains that the functions of accounting are segregated from the functions of receipt and deposit of funds. See page 28.	
Continued effort should be placed on developing procedures designed to reduce or eliminate benefit payments made to retired members after their death.	9
<u>Agency Reply:</u> Concur. See page 28.	
Take the necessary procedures to adapt the general ledger provided by SBAS to the specific requirements of the retirement system.	12
<u>Agency Reply:</u> Concur. See page 28.	
Establish subsidiary ledgers which will provide the necessary information to properly reflect the changes in fund balances for the annuity savings fund, pension	

SUMMARY OF RECOMMENDATIONS (Continued)

	<u>Page</u>
accumulation fund and annuity reserve fund, in accordance with Section 75-6207, R.C.M. 1947.	13
<u>Agency Reply:</u> Concur. See page 29.	
Reconcile subsidiary ledgers to the control totals maintained in the general ledger on a monthly basis.	13
<u>Agency Reply:</u> Concur. See page 29.	
Evaluate the need for formal budgeted entries and determine consistent procedures which will aid in the meaningful preparation of interim financial statements.	13
<u>Agency Reply:</u> Concur and the recommendation will be discussed with the accounting division and, if appropriate, will be implemented. See page 29.	
The retirement board should review a random sample of applications for refunds and document this review in the retirement board minutes.	14
<u>Agency Reply:</u> Do not concur. See page 29.	
The retirement board minutes should be approved and signed in a timely manner.	14
<u>Agency Reply:</u> Concur. See page 30.	
The retirement board minutes should include documentation of all significant agreements entered into by the retirement system.	14
<u>Agency Reply:</u> Concur. See page 30.	
Record depreciation expense annually on the building investment.	15
<u>Agency Reply:</u> Concur. See page 30.	
Consideration should be given to retaining a qualified member of the medical profession to assist in the determination of the degree of incapacity of a member applying for disability benefits.	16
<u>Agency Reply:</u> Do not concur. See page 30.	

SUMMARY OF RECOMMENDATIONS (Continued)

	<u>Page</u>
Determine procedures which would provide for the accurate reporting of social security numbers on I.R.S. Form W-2P.	16
<u>Agency Reply:</u> Concur. See page 31.	
Continued effort should be made to finalize the conversion to the computerized system for membership savings accounts.	18
<u>Agency Reply:</u> Concur. See page 31.	
Membership savings accounts should be reconciled to the control totals within the general ledger as often as practical.	18
<u>Agency Reply:</u> Concur. See page 31.	
Procedures should be implemented which will provide for the strengthening of the internal controls relating to the verification of wages which are reported by the individual agencies of the retirement system.	18
<u>Agency Reply:</u> Concur, however, the agency is of the opinion that the Department of Community Affairs should verify reported wages at the time of the audit of the school districts. See page 30.	

TEACHERS' RETIREMENT SYSTEM
COMMENTS AND RECOMMENDATIONS

General History and Description

The State of Montana Teachers' Retirement System was created under provisions of chapter 87, Laws of 1937. The primary statutes applicable to the system are codified in Title 75, Chapter 62, of the Revised Codes of Montana, 1947. The purpose of the system is to provide a source of financial benefits to members of the public teaching profession after their retirement or upon their becoming disabled.

The system has grown from its initial enrollment of 3,367 members to approximately 18,000 current members. There are approximately 3,700 members and beneficiaries receiving monthly retirement, disability or survivor benefits.

The governing body of the teachers' retirement system is comprised of a five member retirement board whose names are listed on page i of this report. The board consists of the superintendent of public instruction, two members appointed from the teaching profession who are members of the system and two members appointed as representatives of the public. The four appointed members are appointed by the Governor to four-year terms.

The responsibilities of the retirement board include, but are not limited to, the following matters:

1. Establish rules and regulations necessary for the proper administration and operation of the system.
2. Approve or disapprove all expenditures necessary for the proper operation of the system.
3. Determine the eligibility of a person who is applying for membership to the system.
4. Grant retirement, disability and other benefits under the provisions of Section 75-6208, RCM 1947.
5. Annually determine the rate of regular interest as prescribed in Section 75-6206 RCM 1947.

6. Establish and maintain the funds of the retirement system in accordance with the provisions of Section 75-6207 R.C.M. 1947.

The State Board of Investments invests the funds of the system in various securities permitted by law. This function was transferred from the retirement board pursuant to the executive reorganization act of 1971.

The Attorney General acts as legal advisor to the system with the State Treasurer being the custodian of securities and cash.

Membership in the retirement system is compulsory for all members of the teaching profession except for a person who teaches less than six weeks during the absence of a regular teacher and those persons who elected to be non-members when the system was first created.

The system's primary sources of funds are contributions from active member employees, and employers, and from earnings on the system's investments. Currently, active member employees contribute 6 1/8% of their salaries while the member employers contribute 6 $\frac{1}{4}$ % of their employees' salary.

Contributions from member employees are accumulated in the annuity savings fund with individual account balances being maintained for each member.

Contributions from member employers are accumulated in the pension accumulation fund without the use of individual balances.

When member employees retire, the funds they have accumulated plus interest earned is transferred from the annuity savings fund to the annuity reserve fund. These three funds, (annuity savings fund, pension accumulation fund and annuity reserve fund), comprise what is known as the agency or trust fund of the retirement system. Periodically, transfers are made from the system's agency fund to the earmarked revenue fund. The earmarked revenue fund accounts for the administrative expenses of the retirement system. It is codified in Chapter 62, Section 75-6207 R.C.M. 1947. This fund was not included within the scope of our examination and therefore, no expression of

opinion is made within this report as to its fairness.

The retirement system also maintains the Fullam Trust Fund. This fund is the result of a former teacher's estate bequest to the system in 1966. It is comprised almost entirely of investments and earnings on those investments.

The system's offices are located at 1500 Sixth Avenue, Helena, Montana. A staff of nine full-time employees, headed by the executive secretary (administrator) carry out the task of administrating the system. The basement portion of the office building is leased to the Department of Administration and income generated from this lease is recorded in the system's Pension Accumulation Fund along with other investment earnings.

The plan itself has not been qualified by the Internal Revenue Service. The primary reasons for this relate to the terminating procedures and restrictions on the use of the system's funds.

Summary of Previous Audit Recommendations

The last comprehensive independent audit of the system was for the three fiscal years ending June 30, 1974. The report on audit from that examination contained six recommendations. Following is a summary of those recommendations together with comments as to their current status.

1. "Accrue all substantial receivables at the end of each fiscal year."

Not Implemented - The statewide budgeting and accounting system (SBAS) provides the general ledger which is currently being utilized by the retirement system. As of June 30, 1975 and June 30, 1976, no substantial receivables were accrued on the SBAS reports. The accompanying financial statements have been adjusted to reflect contributions receivable of \$2,604,061 and interest receivable on investments of \$1,866,892 at June 30, 1976.

This particular recommendation has appeared on each of the last two reports on audit for the retirement system. It was indicated in the last report that the recommendation to accrue substantial receivables was "partially implemented", as of June 30, 1974. At that time, the retirement system utilized a manual accounting system in conjunction with the computerized system provided by SBAS. The manual system was used to prepare the system's

financial statements at that time. The manual accounting system included "most contributions receivable at June 30, 1974, but most accrued interest earnings were not recorded". For this reason, the recommendation to accrue substantial receivables was deemed to be partially implemented. Since that time however, the retirement system has discontinued the use of the manual accounting system and the computerized SBAS system has been utilized in the preparation of the accompanying financial statements. At no time during the period covered by our examination have any substantial receivables been accrued on the SBAS system. For this reason, the recommendation to accrue substantial receivables is currently deemed to be not implemented.

The basis for the recommendation to accrue substantial receivables has not changed from the past two audits. It is felt that the matching of revenue and expenditures within the same fiscal year is important from both a financial statement and actuarial standpoint. However, upon further evaluation it was determined that the retirement system is unaware of its receivables until they are collected. This poses a problem because in many instances the payment of employee and employer contributions are not received until several months after they are due. In cases such as these the employees who have had contributions withheld from their wages do not begin to earn interest on their contribution until the funds are received by the retirement system. In effect, they are penalized due to the inability of the local clerks to submit their reports in a timely manner.

In view of the above discussions, it is our opinion that the retirement system could provide a timely accrual of substantial receivables if the reporting agencies and school districts were required to submit their contributions report to the retirement system within a specified time period or incur a penalty for late filing. The penalty rather than to the individual member should be chargeable to the reporting agency. It should be of a sufficient magnitude to provide an incentive for timely filing and to reimburse the member account for interest lost.

Recommendation #1

Substantial receivables should be accrued at the end of each fiscal year.

Recommendation #2

Consider proposed legislation which would allow for penalties to reporting agencies for failure to file timely contribution reports.

2. "Include on all journal entries a precise explanation of the nature of the entries or refer to the source where the detailed information is available."

Not Implemented - The need for more detailed information on journal entries is as evident now as in the past. The computerized accounting system which is provided by SBAS has not been totally adapted to meet the specific requirements of the retirement system. As a result of this, the detailed explanations required on the journal entries must be even more explicit than what might be considered normal.

The journal entries should cite precisely what action is being taken, along with a breakdown as to the various funds affected. Also reference should be given to the source documents or back-up information which provides the justification for the journal entry.

If it is found that the standard journal voucher form (271) does not provide sufficient space for the precise explanations which are required, a numbered index file system could be implemented.

The specific weaknesses relating to the SBAS accounting system and the requirements of the retirement system mentioned above, will be discussed in a following portion of our report. At this point, it is sufficient to say that we believe the previous audit recommendation is still appropriate.

Recommendation #3

Include on all journal entries a precise explanation of the nature of the entry and refer to the source where detailed information is available.

3. "Cease maintaining a general ledger that duplicates that provided by SBAS as soon as practical".

Partially Implemented - The manual general ledger was discontinued on June 30, 1975. The last report on audit indicated that "a slight modification would have to be made in the system's accounts used in SBAS". This modification did not occur and as a result the discontinued use of the manual system occurred before it was practical.

The modifications which are required are discussed in our audit recommendation #6.

4. "Segregate the functions of accounting and handling of receipts and deposits".

Not Implemented - This audit recommendation relates to the system's investments in real estate mortgages. Our engagement was limited in scope in that investments were not examined. However, during our study of internal control relating to receipts and deposits, it was determined that the system's accountant still receives payments on the investments in real estate mortgages, initiates the collection reports and sends the receipts to the Board of Investments. This recommendation has appeared on the last two reports on audit. Since the weak internal control situation still exists, the same recommendation continues to be applicable.

Recommendation #4

Segregate the functions of accounting from the receipt and deposit of funds relating to investments in real estate mortgages.

5. "Determine what procedures other states' retirement systems utilize to verify benefit payments cease upon the death of retired members, and implement appropriate procedures."

Partially Implemented (In Progress) - A survey was conducted of other state retirement systems to determine what procedures were being used to verify that benefit payments cease upon the death of retired members. The results of this survey proved to be inconclusive with no direct appropriate procedures being implemented. Additional study of the problem by the retirement board included sending inquiries to banks and confirming a random sample of retirees by telephone. This resulted in the discovery of at least two individuals who continued to receive benefit payments after their death. The payments made to these individuals were subsequently recovered, however, this points out the need to implement appropriate procedures designed to limit this type of transaction.

Recommendation #5

Continued effort should be placed on developing procedures designed to reduce or eliminate benefit payments made to retired members after their death.

6. "Obtain a legal determination in each instance that significant questions exist in the implementation of changes in the benefit payment plans."

Implemented - This recommendation related to certain ambiguities which existed in the statutes regarding the various retirement options the members had to choose from when they retired.

These ambiguities were removed from the statutes with the adoption of proposed legislation effective July 1, 1975.

Internal Accounting Control and Compliance Weaknesses

In conjunction with our examination of the financial statements of the retirement system, we reviewed and tested the records and procedures for compliance with statutory and administrative requirements. We also reviewed and tested the system of internal accounting controls to the extent we considered necessary to conform with generally accepted auditing standards. The purpose of these procedures is to establish a basis for reliance upon the records and

procedures of the system to determine the nature, timing, and extent of other auditing procedures which are deemed necessary for the expression of an opinion on the financial statements. The objective of these procedures is to provide reasonable, but not absolute, assurance that the transactions of the system are executed in accordance with management's authorization, that they are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles, and to provide for accountability of assets.

There are certain inherent limitations which should be recognized when the effectiveness of any system of internal accounting controls is considered. These limitations include misunderstandings of representations made by management, errors in judgment, carelessness or collusion.

It should be pointed out that study and evaluation of the retirement system's internal accounting control and compliance would not necessarily disclose all weaknesses in the system.

However, the following comments pertain to the weaknesses encountered during our examination.

General Ledger

As previously indicated, the general ledger for the retirement system is provided by the statewide budgeting and accounting system (SBAS). The retirement system began using SBAS on July 1, 1970 in conjunction with a manual general ledger maintained by the system's accountant. On June 30, 1975 the manual system was discontinued and currently the SBAS system is the only general ledger being maintained.

During the initial stages of our examination it became increasingly apparent that the SBAS system as it currently exists does not provide adequate control totals over the various accounts required to prepare meaningful financial statements. The various funds, (annuity savings, pension accumulation and

annuity reserve), which combine to form the agency fund are not being maintained individually as required by Section 75-6207 R.C.M. 1947. Proper segregation of various transactions was not being performed as is evidenced by the fact that refunds, contributions, real estate mortgages and cancellations are combined into one account titled uncleared collections. The uncleared collections account, which is reflected as a liability in the general ledger, was closed out at the end of the 1976 fiscal year directly to the fund balances without being reflected in the section of the general ledger reserved for income and expenditures. The balance in this account amounted to over \$19,000,000 at June 30, 1976.

Another example of the non-segregation of various transactions is that benefit payments are comingled with rental expenses, cancellations and other income. For the purposes of the accompanying financial statements, the appropriate adjustments have been made to properly reflect the results of these and similar transactions.

However, the above examples indicate the need to adapt the general ledger provided by SBAS to meet the needs and requirements of the retirement system. The general ledger should provide a summarization of the various transactions which occur in the system. Control accounts should be maintained on the general ledger and if necessary, subsidiary ledgers should be maintained to distinguish between the funds involved. These subsidiary ledgers should be reconciled to the control accounts on a monthly basis.

During further evaluation of the general ledger of the retirement system, it became apparent that the system has not been consistent in regard to its budgeted activity. During the 1974-1975 fiscal year the system made entries to reflect the budgeted activity of contributions, investment earnings and rental income. However, during the 1975-1976 fiscal year the budgeted activity entered on the general ledger consisted of only investment earnings and

rental income. Since these entries serve to increase the various fund balances of the system the fact that contributions were budgeted in one year and not in the next year makes it difficult to make meaningful comparisons of the fund balances for interim financial statement purposes. Also, the fact that expenditures are not budgeted causes an over-statement of the fund balances for interim financial statement purposes.

It is our opinion that since the system accrues its receivables only at the end of each fiscal year, it would seem appropriate that the cash basis of accounting be used for interim financial statement purposes with an adjustment to the accrual basis of accounting at fiscal year end.

Furthermore, as pointed out in the industry audit guide for Audits of State and Local Governmental Units, "the adoption of a budget providing for estimates of operating revenue and expenses is recommended as an aid to good management and sound financial planning. However, for purposes of achieving flexibility in management and financial planning, authorities generally recommend that such budgets be retained in memorandum form and not be subjected to formal budgeting accounting and control". The preceding quote pertains to enterprise funds and is applicable in this case since the agency fund of the retirement system is similar to an enterprise fund in several respects.

In review of the above discussions, we make the following recommendations:

Recommendation #6

Take the necessary procedures to adapt the general ledger provided by SBAS to the specific requirements of the retirement system.

These procedures should assure that individual accounts or control totals are maintained for:

- (1) Contributions
- (2) Investment earnings
- (3) Miscellaneous income
- (4) Benefit payments
- (5) Refunds
- (6) Rental expenses
- (7) Annuity savings fund

- (8) Pension accumulation fund
- (9) Annuity reserve fund

Along with accounts currently being maintained on an individual basis, such as:

- (1) Cash
- (2) Investments
- (3) Land
- (4) Buildings
- (5) Transfers to earmarked revenue account

Recommendation #7

Establish subsidiary ledgers which will provide the necessary information to properly reflect the changes in fund balances for the annuity savings fund, pension accumulation fund and annuity reserve fund, in accordance with Section 75-6207 R.C.M. 1947.

Recommendation #8

Reconcile subsidiary ledgers to the control totals maintained in the general ledger on a monthly basis.

Recommendation #9

Evaluate the need for formal budgeted entries and determine consistent procedures which will aid in the meaningful preparation of interim financial statements.

Retirement Board Minutes

The approved minutes of the retirement board should play an important role in the overall system of internal control. The retirement board is responsible to approve or disapprove all expenditures relating to the operation of the system. Currently the board reviews all applications for retirement, disability and survivor benefits. Applications for refunds are not approved by the retirement board.

Currently, there are over 1,500 refund applications processed each year by the retirement system. The volume of these transactions alone makes it impractical for the retirement board to review and approve each refund application. However, since expenditures for refunds are of a substantial nature, it is our feeling that the retirement board should review a random sample of the refund applications and expenditures made for this purpose. This can

only help to improve the internal accounting controls related to this area.

In all instances the retirement board minutes should be approved and signed by the board in a timely manner. This would allow the retirement board minutes to play a significant role in the overall system of internal control in that it would provide a reference of the approved benefit expenditures of the system.

The board minutes should also be used to document all significant agreements entered into by the retirement system. Our examination indicated that this was being done in all but one instance. In view of the preceding discussion we make the following recommendations:

Recommendation #10

The retirement board should review a random sample of applications for refunds and document this review in the retirement board minutes.

Recommendation #11

The retirement board minutes should be approved and signed in a timely manner.

Recommendation #12

The retirement board minutes should include documentation of all significant agreements entered into by the retirement system.

Land and Building

During our examination of the land and building of the retirement system our study of internal accounting controls yielded no major weaknesses. There appeared to be an adequate accountability of the assets. It should be pointed out, however, that the procedures used in recording depreciation on the building are less than adequate. During the 1974-1975 fiscal year, no depreciation was recorded. During the 1975-1976 fiscal year, the 1974-1975 fiscal year depreciation was recorded directly to the agency fund balance with no provision for the 1975-1976 fiscal year depreciation. Although the accompanying financial statements have been adjusted to properly reflect this activity, it is our opinion that depreciation expense should be recorded currently on an

annual basis.

Recommendation #13

Record depreciation expense annually on the building investment.

Benefits

The internal accounting controls being utilized by the system in regard to benefits appear to be adequate. Our confirmation of selected benefit payments with the individuals receiving them did not reveal any unexplainable monetary discrepancies. However, there are a few weaknesses which bear mention.

The problem of assuring that benefit payments cease upon the death of retired members was addressed in the discussions leading to recommendation #5. We feel that no further comment is necessary.

Additionally, there is a weakness in regard to the procedures used when an individual applies for disability benefits. Currently the personal physician of the disabled member submits a physician's statement which indicates the physician's opinion as to the permanency of the incapacity of the member. This statement is utilized by the retirement board to assist in making a determination as to the eligibility of the member to draw disability benefits.

In many instances the descriptions and explanations contained in these statements are quite technical and require further clarification. It is our opinion that when this type of situation exists, the retirement board should retain a qualified member of the medical profession to aid in their determination as to the eligibility of the member to draw a disability benefit.

Another area which indicates a possible weakness in the internal accounting controls relating to benefits is that in several instances, the social security number which was confirmed by the member or beneficiary was not the same number as was on file with the system. This occurs because the social security number of the member is used as the account number for the system and is not always changed to the beneficiary's social security number when the member dies. This creates a

problem when annual statements (Internal Revenue Service, Form W-2P) are mailed to persons collecting benefits. These statements are required to indicate the amount of benefits received by the individual which are taxable as ordinary income and the social security number of the person actually receiving the benefit. In many instances the social security number which appears on this statement is the original member's even though the benefit is received by the beneficiary.

It is our opinion that in order to avoid this situation, the social security number of the beneficiary should be used as the account number of the system when the original member dies. This would assure that the reporting requirements imposed by the I.R.S. are satisfied.

Recommendation #14

Consideration should be given to retaining a qualified member of the medical profession to assist in the determination of the degree of incapacity of a member applying for disability benefits.

Recommendation #15

Determine procedures which would provide for the accurate reporting of social security numbers on I.R.S. Form W-2P.

Membership Savings Accounts

As previously indicated, contributions from member employees are required to be maintained in individual accounts within the annuity savings fund in accordance with the provisions of Section 75-6207 R.C.M. 1947.

At the time of the last audit report, the individual balances in these accounts were being maintained on a manual system. On July 1, 1974, the system began converting from this manual system to a computerized system for membership savings accounts. The manual system was discontinued on approximately December 1, 1974. At the date of this report, the transition to the computerized system was not 100% complete and we have been unable to obtain a balanced listing of the membership savings accounts at June 30, 1976. The lack of individual account

balances has caused us not to confirm the balance in the membership savings accounts with a random sample of the individual members. This problem is compounded when it is considered that a control total is not maintained for the annuity savings fund.

The weakness which exists in membership savings accounts has had a negative effect upon both refunds and transfers to the annuity reserve fund for members who have retired. In many instances, refunds have been calculated prior to the actual postings to the membership accounts. This has increased the possibility of refunding an incorrect amount to a member who has withdrawn from the system. Additionally, transfers to the annuity reserve fund cannot be made for members who have retired until a correct balance is obtained in the membership savings accounts. This has caused the annuity savings fund to be overstated and the annuity reserve fund to be understated in the accompanying financial statements.

Currently, the membership savings accounts have been posted through June 30, 1976 but have not been reconciled to the individual reporting agencies. This reconciliation procedure was necessitated by the fact that the annuity savings fund was not maintained for the contributions from member employees.

It is quite obvious that the retirement system's first priority should be to take the necessary steps to finalize the conversion to the computerized system for membership savings accounts. The balances which are obtained should be summarized in the general ledger with the establishment of the annuity savings fund. The balance in this fund should be reconciled to the listing of membership savings accounts on a monthly basis or as often as practical. Transfers to the annuity reserve fund for members who have retired should be made in a timely manner.

Another weakness which exists in regard to membership savings accounts is the lack of procedures designed to assure that the funds which are collected

from the individual reporting agencies are in fact correct. Procedures are implemented which verify that the amount contributed is the correct percentage of the reported wages. However, there are no procedures which verify that the reported wages are correct.

In review of this weakness, it was determined that the Department of Community Affairs does perform a limited review of the payroll deductions withheld from members of the retirement system. This review includes the amounts withheld for contributions to the retirement system on a sample basis. Additionally, no special audit procedures are performed by the Department of Community Affairs in respect to the Teachers' Retirement System.

It is our opinion that the weakness in the internal controls relating to the verification of reported wages are not materially strengthened by the limited procedures performed by the Department of Community Affairs. Additional procedures should be implemented which are designed to provide reasonable assurance that the reported wages are correct. When the cost of auditing a sample of the school districts is considered, it is our opinion that since the Department of Community Affairs currently performs limited auditing procedures in regard to this area, the retirement board should consider meeting with a representative of the Department to develop procedures which can be implemented to strengthen the procedures currently in use.

In view of the above discussions, the following recommendations are made:

Recommendation #16

Continued effort should be made to finalize the conversion to the computerized system for membership savings accounts.

Recommendation #17

Membership savings accounts should be reconciled to the control totals within the general ledger as often as practical.

Recommendation #18

Procedures should be implemented which will provide for the

strengthening of the internal controls relating to the verification of wages which are reported by the individual agencies of the retirement system.

Conclusion

The contents of this report have been reviewed with the administrator of the retirement system along with the pertinent members of his staff. We would like to extend our appreciation for the cooperation extended us by all of those involved during the course of our engagement.

Bozeman, Montana
December 22, 1976

Holmes & Turner
CERTIFIED PUBLIC ACCOUNTANTS

WILLIAM B. HOLMES, C.P.A.
ERNEST J. TURNER, C.P.A.

300 NORTH WILLSON
P O BOX 1246 • BOZEMAN, MONTANA 59715
(406) 587-4266

The Legislative Audit Committee of the
Montana State Legislature:

We have examined the financial statements of the agency fund of the Montana Teachers' Retirement System for the two fiscal years ended June 30, 1976, listed in the foregoing table of contents. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and other such auditing procedures as we considered necessary in the circumstances, except as noted in the following paragraph.

Because of major inadequacies in the system's accounting records for members' savings and fund transfers upon retirement, it was not practical to extend our auditing procedures to enable us to express an opinion on the financial statements listed in the foregoing table of contents as they relate to the Annuity Savings Fund, Pension Accumulation Fund and Annuity Reserve Fund at June 30, 1976 and the results of operations of such funds for the two fiscal years then ended.

We did not examine the investments or investment income of the Trust Fund, which investments and related income constitute 35 percent and 29 percent respectively of the related totals. These investments were examined by other auditors whose report thereon has been furnished to us, and our opinion expressed herein, insofar as it relates to the amounts included for investments and investment income, is based solely on the opinion of the other auditors.

In our opinion, except for the effect of not stating investments at market value and not recognizing unrealized gains and losses, as stated in the report of the other auditors who audited the investments and investment income, the financial statements listed in the foregoing table of contents relating to the Agency Fund in total present fairly the financial position of the Agency Fund at June 30, 1976 and the results of operations of said fund for the two fiscal years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Holmes & Turner

Bozeman, Montana
December 22, 1976

FINANCIAL STATEMENTS

TEACHERS' RETIREMENT SYSTEM
AGENCY FUND
BALANCE SHEET
JUNE 30, 1976
Exhibit A

ASSETS

Cash in State Treasury	\$ (352,457)
Interest receivable on investments (Note 1)	1,866,892
Contributions receivable	2,604,061
Investments (Note 2)	
Repurchase agreements	\$ 1,931,000
U.S. Treasury obligations	482,889
Government agency obligations	1,155,626
U.S. Government guaranteed obligations	2,490,625
Canadian obligations	8,758,736
Corporate obligations	75,602,024
Common stock	6,680,056
Montana mortgages	21,432,474
Land and building (Note 3)	<u>170,087</u>
	118,703,517
Deferred obligations	
Actuarial reserve deficiency as of June 30, 1975 (Note 4)	<u>219,345,049</u>
	<u>\$342,167,062</u>

LIABILITIES AND FUND BALANCE

Unfinanced accrued liability	
Actuarial reserve deficiency as of June 30, 1975 (Note 4)	\$219,345,049
Fund balance	<u>122,822,013</u>
	<u>\$342,167,062</u>

The accompanying notes are an integral part of these financial statements

TEACHERS' RETIREMENT SYSTEM
AGENCY FUND
STATEMENT OF CHANGES IN FUND BALANCE
TWO FISCAL YEARS ENDED JUNE 30, 1976
Exhibit B

	<u>Annuity Savings Fund</u>	<u>Pension Accumulation Fund</u>	<u>Annuity Reserve Fund</u>	<u>Agency Fund Total</u>
Fund balance, July 1, 1974	\$56,081,408	\$24,418,217	\$15,169,468	\$ 95,669,093
Add:				
Revenue (Exhibit C)				
1974-1975	7,855,606	14,550,968	-	22,406,574
1975-1976	11,451,575	18,965,940	-	30,417,515
Deduct:				
Expenditures (Exhibit D)				
1974-1975	1,521,202	8,756,058	1,602,296	11,879,556
1975-1976	1,662,436	10,050,406	1,650,559	13,363,401
Transfers to earmarked revenue fund				
1974-1975	-	195,000	-	195,000
1975-1976	-	233,212	-	233,212
Intra-fund transfers (Note 5)	-	-	-	-
Fund balance, June 30, 1976 (Note 6)	<u>\$72,204,951</u>	<u>\$38,700,449</u>	<u>\$11,916,613</u>	<u>\$122,822,013</u>

The accompanying notes are an integral part of these financial statements.

TEACHERS' RETIREMENT SYSTEM
AGENCY FUND
STATEMENT OF REVENUE
TWO FISCAL YEARS ENDED JUNE 30, 1976
Exhibit C

	Annuity Savings <u>Fund</u>	Pension Accumulation <u>Fund</u>	Annuity Reserve <u>Fund</u>	Agency Fund <u>Total</u>
Member contributions (Note 7)				
1974-1975	\$ 7,855,606	\$ -	\$ -	\$ 7,855,606
1975-1976	11,451,575	-	-	11,451,575
Employer contributions (Note 8)				
1974-1975		7,415,164	-	7,415,164
1975-1976		10,860,867	-	10,860,867
Investment income (Note 9)				
1974-1975		7,114,139		7,114,139
1975-1976		8,076,379		8,076,379
Other income				
1974-1975		21,665	-	21,665
1975-1976		28,694		28,694
Total revenue for two year period	<u>\$19,307,181</u>	<u>\$33,516,908</u>	<u>\$ -</u>	<u>\$52,824,089</u>
Total by fiscal year				
1974-1975	\$ 7,855,606	\$14,550,968	\$ -	\$22,406,574
1975-1976	11,451,575	18,965,940	-	30,417,515
	<u>\$19,307,181</u>	<u>\$33,516,908</u>	<u>\$ -</u>	<u>\$52,824,089</u>

The accompanying notes are an integral part of these financial statements.

TEACHERS' RETIREMENT SYSTEM
AGENCY FUND
STATEMENT OF EXPENDITURES
TWO FISCAL YEARS ENDED JUNE 30, 1976
Exhibit D

	Annuity Savings Fund	Pension Accumulation Fund	Annuity Reserve Fund	Agency Fund <u>Total</u>
Retirement benefits				
1974-1975	\$ 1,830	\$ 8,702,233	\$ 1,551,672	\$10,255,735
1975-1976	140	10,032,503	1,650,328	11,682,971
Member withdrawal refunds (Note 10)				
1974-1975	1,527,018	53,114	30,080	1,610,212
1975-1976	1,677,461	35,640	3,157	1,716,258
Depreciation on investment in office building				
1974-1975		3,963		3,963
1975-1976		3,963		3,963
Stale dated warrants and cancellations				
1974-1975	(8,998)	(20,360)	(2,490)	(31,848)
1975-1976	(15,165)	(28,668)	(2,926)	(46,759)
Other expenses				
1974-1975	1,352	17,108	23,034	41,494
1975-1976	-	6,968	-	6,968
Total expenditures for two year period	<u>\$3,183,638</u>	<u>\$18,806,464</u>	<u>\$3,252,855</u>	<u>\$25,242,957</u>
Total by fiscal year				
1974-1975	\$1,521,202	\$ 8,756,058	\$1,602,296	\$11,879,556
1975-1976	1,662,436	10,050,406	1,650,559	13,363,401
	<u>\$3,183,638</u>	<u>\$18,806,464</u>	<u>\$3,252,855</u>	<u>\$25,242,957</u>

The accompanying notes are an integral part of these financial statements.

TEACHERS' RETIREMENT SYSTEM
NOTES TO FINANCIAL STATEMENTS
TWO FISCAL YEARS ENDED JUNE 30, 1976

1. Interest Receivable

These financial statements reflect investment interest receivable at June 30, 1975 and June 30, 1976 of \$1,503,499 and \$1,866,892 respectively. These amounts were obtained by direct confirmation with other independent auditors who examined the investments of the retirement system. No additional auditing procedures were performed in regard to interest receivables.

2. Investments

Due to a limitation in scope, we did not examine the investments of the retirement system except for the investment in land and building (Note 3). Our examination was limited to a direct confirmation of the system's investments with other independent auditors who performed this examination. This confirmation revealed that U.S. Government obligations, Corporate bonds and Canadian obligations are shown at original cost adjusted for amortization of premium or accumulation of discount. Mortgages are shown at par value, with all other securities shown at original cost. See related footnotes number 1 and 9.

3. Land and Building

The investment in land and building is reflected at costs of \$35,376 and \$158,468 respectively. Accumulated depreciation of \$23,757 is reflected against the building investment resulting in a net book value of \$170,087.

4. Deferred Obligations - Unfinanced Accrued Liability

The amount of \$219,345,049 reported as deferred obligations and unfinanced accrued liability on the balance sheet as of June 30, 1976, represents the unfunded accrued liability as determined by the system's contracted actuary as of June 30, 1975. The Teachers' Retirement Board has adopted the policy of having an independent actuarial review made every two years. Accordingly, the June 30, 1975 balance is the latest available. The unfunded accrued liability of \$219,345,049 as of June 30, 1975 compares to an unfunded accrued liability of \$112,189,085 as of June 30, 1973.

5. Intra-Fund Transfers

Transfers of accumulated member contributions plus interest earned on those contributions are transferred from the annuity savings fund to the annuity reserve fund when a member employee retires. These transfers have not been made on the accounting records of the retirement system due to problems the retirement system has experienced in converting from a manual to a computerized system for membership savings accounts. These transfers cannot be made until the balances in the

5. Intra-Fund Transfers, continued.

individual membership accounts have been verified.

Earnings from the retirement systems' investments are reflected in the pension accumulation fund. A portion of the investment earnings is required to be transferred from the pension accumulation fund to the annuity savings fund to compensate for the interest which is earned on member employees contributions. This transfer has been delayed until the balance in the individual membership accounts have been verified.

6. Fund Balance

Due to the intra-fund transfers (Note 5) not being made, the individual fund balances which constitute the agency fund balance of \$122,822,013 at June 30, 1976 are misstated. This misstatement of individual fund balances does not affect the total agency fund balance as of June 30, 1976.

7. Member Contributions

Pursuant to legislation enacted in 1975, member contributions were increased effective July 1, 1975 from 5.125% of salaries to 6.125% of salaries. Member contributions exceed employer contributions in total primarily due to repayments made by members who have previously withdrawn and contributions made for out-of-state service.

8. Employer Contributions

Pursuant to legislation enacted in 1975, employer contributions were increased effective July 1, 1975 from 5.25% of salaries to 6.25% of salaries.

9. Investment Income

Investment income of \$7,114,139 and \$8,076,379 is reflected for the fiscal years ended June 30, 1975 and June 30, 1976 respectively. These amounts were obtained by direct confirmation with other independent auditors who examined the investments of the retirement system. No additional auditing procedures were performed in regard to investment income. See related footnotes number 1 and 2.

10. Member Withdrawal Refunds

Legislation passed in 1973, provided for the payment of interest after July 1, 1973, on all withdrawals of member contributions. Member withdrawal refunds include interest earned on contributions of \$178,843 and \$194,086 for the fiscal years ended June 30, 1975 and June 30, 1976 respectively.

AGENCY REPLY

The Teachers Retirement System



State of Montana

1500 Sixth Ave. Phone 406-449-3134
HELENA, MONTANA 59601

MEMBERS OF THE BOARD

J WILLIAM KEARNS, JR., Townsend, Chairman
JAMES E BURKE, Livingston
JAMES N DENNEHY, Butte
LORENCE B SIMONSEN, Shelby
DOLORES COLBERG,
State Supt of Public Instruction, Ex Officio

OWEN L. MORRIS, JR., Executive Secretary
F ROBERT JOHNSON, Ass't. Executive Secretary

January 24, 1977

RECEIVED
JAN 25 1977

MONTANA LEGISLATIVE AUDITOR

Morris L. Brusett
Legislative Auditor
Capitol Building
Helena, Montana 59601

Dear Mr. Brusett:

The following is our response to the recommendations contained in the report of the audit of the Teachers' Retirement System performed by Holmes and Turner, Certified Public Accountants.

RECOMMENDATION #1: Page 7

Substantial receivables should be accrued at the end of each fiscal year.

RESPONSE:

We concur in this recommendation.

RECOMMENDATION #2: Page 7

Consider proposed legislation which would allow for penalties to reporting agencies for failure to file timely contribution reports.

RESPONSE:

We do not concur in this recommendation. It is our intention to contact the reporting officials for the various agencies in an attempt to obtain the June reports and related contributions by June 30. If we are successful, this will allow us to accrue substantial receivables at the end of the fiscal year and will preclude the necessity for legislation which would provide penalties for late reporting.

Morris L. Brusett
Page -2-
January 24, 1977

RECOMMENDATION #3: Page 8

Include on all journal entries a precise explanation of the nature of the entry and refer to the source where detailed information is available.

RESPONSE:

We concur in this recommendation.

RECOMMENDATION #4: Page 9

Segregate the functions of accounting from the receipt and deposit of funds relating to investments in real estate mortgages.

RESPONSE:

We do not agree with this recommendation. The mortgage payments are logged in by the records clerk when the mail is opened. The checks are then given to the accounting clerk who makes up the deposit document. The accountant only receives the report of the real estate mortgages so that the functions of accounting and the receipt and deposit of funds are segregated.

RECOMMENDATION #5: Page 9

Continued effort should be placed on developing procedures designed to reduce or eliminate benefit payments made to retired members after their death.

RESPONSE:

We concur in this recommendation. We have continued our effort on developing procedures to reduce or eliminate benefit payments to retired members after their death. We have discussed this matter with the State Auditor and are hopeful of having the words "if living" printed on the retirement warrants, either at the time the warrants are printed, or when they are addressed by the computer.

RECOMMENDATION #6: Page 12

Take the necessary procedures to adapt the general ledger provided by SBAS to the specific requirements of the retirement system.

RESPONSE:

We concur with this recommendation.

Morris L. Brusett
Page -3-
January 24, 1977

RECOMMENDATION #7: Page 13

Establish subsidiary ledgers which will provide the necessary information to properly reflect the changes in fund balances for the annuity savings fund, pension accumulation fund and annuity reserve fund, in accordance with Section 75-6207 R.C.M. 1947.

RESPONSE:

We concur in this recommendation.

RECOMMENDATION #8: Page 13

Reconcile subsidiary ledgers to the control totals maintained in the general ledger on a monthly basis.

RESPONSE:

We concur in this recommendation.

RECOMMENDATION #9: Page 13

Evaluate the need for formal budgeted entries and determine consistent procedures which will aid in the meaningful preparation of interim financial statements.

RESPONSE:

This recommendation will be discussed with the accounting division and, if appropriate, will be implemented.

RECOMMENDATION #10: Page 14

The retirement board should review a random sample of applications for refunds and document this review in the retirement board minutes.

RESPONSE:

We do not concur in this recommendation. The retirement board does not feel that it is appropriate to review a random sample of applications for refund and document this review in the retirement board minutes. The random sampling of the withdrawals is accomplished at the time of our biennial audit and provides a much better check than that which might be accomplished by the retirement board, which meets only quarterly, and is not familiar with the withdrawal or refund procedures.

Morris L. Brusett
Page -4-
January 24, 1977

RECOMMENDATION #11: Page 14

The retirement board minutes should be approved and signed in a timely manner.

RESPONSE:

We concur in this recommendation. All retirement board minutes are approved and signed.

RECOMMENDATION #12: Page 14

The retirement board minutes should include documentation of all significant agreements entered into by the retirement system.

RESPONSE:

We concur in this recommendation.

RECOMMENDATION #13: Page 15

Record depreciation expense annually on the building investment.

RESPONSE:

We concur in this recommendation. Depreciation expense is generally recorded annually on the building investment, however, the depreciation for 1974-75 failed to be recorded, but the necessary adjustments have been made. In the future, the depreciation expense will be recorded on an annual basis.

RECOMMENDATION #14: Page 16

Consideration should be given to retaining a qualified member of the medical profession to assist in the determination of the degree of incapacity of a member applying for disability benefits.

RESPONSE:

We do not concur in this recommendation. It is the opinion of the retirement board that there is no need to retain a qualified member of the medical profession on a permanent basis to assist in determination of the degree of incapacity of a member applying for disability benefits. It is the practice of the board to solicit additional information from the physician completing the physician's statement, if the information is not sufficiently detailed to provide the board with information it requires in order to make a determination whether the individual qualifies for disability benefits.

Morris L. Brusett
Page -5-
January 24, 1977

RECOMMENDATION #15: Page 16

Determine procedures which would provide for the accurate reporting of social security numbers on I.R.S Form W-2P.

RESPONSE:

We concur in this recommendation.

RECOMMENDATION #16: Page 18

Continued effort should be made to finalize the conversion to the computerized system for membership savings accounts.

RESPONSE:

We concur in this recommendation.

RECOMMENDATION #17: Page 18

Membership savings accounts should be reconciled to the control totals within the general ledger as often as practical.

RESPONSE:

We concur in this recommendation.

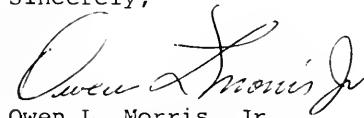
RECOMMENDATION #18: Page 18

Procedures should be implemented which will provide for the strengthening of the internal controls relating to the verification of wages which are reported by the individual agencies of the retirement system.

RESPONSE:

We concur with this recommendation, however, we are of the opinion that verification of the wages reported should be accomplished at the time of the audit of the school district by the Department of Community Affairs. This matter will be discussed with the Department of Community Affairs.

Sincerely,



Owen L. Morris, Jr.
Executive Secretary

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